

Commonwealth of Pennsylvania Public School Employees' Retirement System

DATE: April 17, 2009

SUBJECT: Investment Manager Recommendation

TO: Members of the Board

FROM: Mark E. Heppenstall, CFA
Managing Director of Fixed Income

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Managing Director of External Public Markets, Risk & Compliance

At the Finance Committee meeting in April, staff and Wilshire will recommend an investment with TWC Asset Management Company in an opportunistic mortgage-backed securities separately managed account. This account will invest primarily in non-agency senior and super senior portions of the capital structure (prime and Alt-A mortgages). Staff, Wilshire, and TCW believe that the return opportunities in this segment of the fixed income market can generate returns in the mid- to high-teens. TCW is an existing manager who is managing a credit opportunities fund and has done a very good job of scaling into the credit markets since they were hired in May 2008.

Staff, Wilshire, and TCW believe that there is currently a significant market opportunity to earn superior risk adjusted returns due to the dislocations in the credit markets. There are over \$2.1 trillion in non-agency mortgages outstanding with yields ranging between 14% and 20%. These securities are trading at between 50 and 80 cents on the dollar as forced selling and liquidations continue. TCW believes that a significant repricing of mortgage credit risk has been underway which has created pockets of inefficiency and discounting of select securities to which staff would concur.

TCW and staff believe that an investment window for this asset class is limited. Government programs established during the past few months have caused technicals to improve in this market. Mortgage rates have fallen below 5% which is increasing prepayments. In addition, the new Public-Private Investment Partnership, once under way, may increase upward pricing pressure as asset managers compete for securities. This plan entails the US Treasury matching funds and providing low-cost long-term non-recourse leverage for certain select managers to purchase these securities. It is both the government's and TCW's opinion that this program will result in meaningful price appreciation over time for these assets.

TCW would manage a separate account for PSERS. This account structure has the advantages of complete transparency and immediate liquidity should PSERS require it. This structure differs from the government programs which will allow investors to leverage returns but comes at a cost of a three-year commitment of capital in a commingled fund. Staff and Wilshire are recommending an investment of up to \$500 million in this opportunity.

If you have any questions or comments, please contact me at 717-720-4703.